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"A Study of Commodity market in India, its Issues and Challenges"

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ABSTRACT

Commodities are raw materials that are sold in bulk, such as oil, wheat, silver, gold, pork bellies, oranges and cocoa. They are generally raw materials that are eventually used to produce other goods such as oil for gasoline, cocoa for chocolate, wheat for bread; etc The history of organized commodity in India goes back to the nineteenth century when Cotton Trade Association started futures trading in 1875, about a decade after they started in Chicago. Over the time datives market developed in several commodities in India. Following Cotton, derivatives trading started in oilseed in Bombay (1900), raw jute and jute goods in Calcutta (1912), Wheat in Hapur (1913) and Bullion in Bombay (1920). Commodities actually offer immense potential to become a separate asset class for market-savvy investors, arbitrageurs and speculators. Retail investors, who claim to understand the equity markets, may find commodities an unfathomable market. But commodities are easy to understand as far as fundamentals of demand and supply are concerned.. This paper discusses about the structure of commodity market in India, what are the different types of issues and challenges as faced by the commodity market in the present scenario. The commodities market will have three broad categories of market participants apart from brokers and the exchange administration - hedgers, speculators and arbitrageurs. Brokers will intermediate, facilitating hedgers and speculators. The government has now allowed national commodity exchanges, similar to the BSE & NSE, to come up and let them deal in commodities in an electronic trading environment, in this regard, four commodity exchanges have been approved to commence business in this regard. They are: 1) Multi Commodity Exchange (MCX) located at Mumbai 2) National Commodity and Derivatives Exchange Ltd (NCDEX) located at Mumbai 3) National Board of Trade (NBOT) located at Indore 4) National Multi Commodity Exchange (NMCE) located at Ahmedabad.

Keywords: Commodity Markets, Commodity Exchanges, Market Participants.

I) INTRODUCTION:

Indian markets have recently thrown open a new avenue for retail investors and traders to participate: commodity derivatives. For those who want to diversify their portfolios beyond shares, bonds and real estate, commodities are the best option. Commodities actually offer immense potential to become a separate asset class for market-savvy investors, arbitrageurs and speculators. Retail investors, who claim to understand the equity markets, may find commodities an unfathomable market. But commodities are easy to understand as far as fundamentals of demand and supply are concerned. Retail investors should understand the risks and advantages of trading in commodities futures before taking a leap. Historically, pricing in commodities futures has been less volatile compared with equity and bonds, thus providing an efficient portfolio diversification option. Like any other market, the one for commodity futures plays a valuable role in information pooling and risk sharing. The market mediates between buyers and sellers of commodities, and facilitates decisions related to storage and consumption of commodities. In the process, they make the underlying market more liquid.

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II) OBJECTIVES OF STUDY:

1) To study the history and evolution of Indian Commodity Market.
2) To study the different forms of investing in Indian commodity markets.
3) To study the different segments of Indian Commodity Markets.
4) To analyze the regulatory framework of commodity market in India.
5) To study the challenges as faced by commodity market in India.

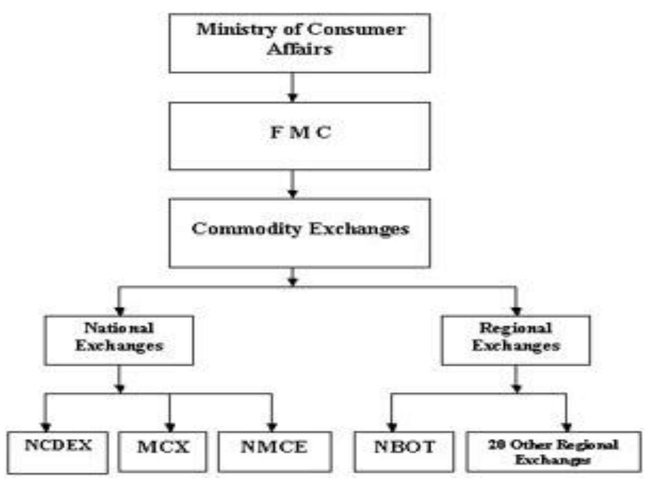
III) REVIEW OF LITERATURE:

After Studying the literature available on the commodity market in general, we get a theoretical explanation for the emergence of commodity market. There are many studies which examines the market efficiency and price forecasting. Sumit Gupta (2008) explains the economic functions of the commodity futures market, regulations of the commodity derivative market and the present scheme of regulation in Indian commodity derivatives market and the economic functions of the commodity futures market includes market creation by entering into futures contract. The regulation of commodity market is required to ensure that market efficiently performs the twin economic functions of price discovery and price risk management to properly integrate spot and futures prices, to provide protection against risk of volatility in prices. Pravakar sahoo and Rajiv Kumar (2009) has evaluated that trading in commodity derivatives on exchange platform is an instrument to achieve price discovery, better price risk management besides helping macro economy with better resource allocation. The govt. has proposed to impose transaction tax by 0.017% of trading volume in the 2008-2009 budgets. He examine the efficiency and futures trading price nexus for 5 top selected commodities namely gold, copper, petroleum crude, soya oil and chana in commodity futures market in India. He suggests that commodity futures market is efficient for all 5 commodities. Further he has not supported that futures market leads to higher inflation due to lack of evidence.

IV) METHODOLOGY:

The present study is conducted on commodity markets in India. The study is descriptive in nature. The literature and data are mainly based on a secondary source which has been collected from commodity market and their various publications, text book related topics, magazines, reputed journals, newspapers, and various internet sources like www.mcxindia.com, www.ncdexindia.com, www.nmceindia.com, www.fmce.gov.in and other publications. The various reports and records issues as maintained by Government of India (GOI) are also used in this study. This study is based on historical background of commodity markets in India & its policies and designed to gather descriptive information's. There is no tool applied to values and volume fluctuations of the commodity market.

V) STRUCTURE OF COMMODITY MARKETS IN INDIA:



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Leading Commodity Markets in India

The government has now allowed national commodity exchanges, similar to the BSE & NSE, to come up and let them deal in commodity derivatives in an electronic trading environment. These exchanges are expected to offer a nation-wide anonymous, order driven screen based system for trading. The Forward Markets Commission (FMC) regulates these exchanges. Major commodity exchanges in India are namely: MCX (Multi commodity exchange) located at Mumbai, NCDEX (National commodity and derivatives exchange ltd) located at Mumbai. NMCE (National multi commodity exchange ltd) located at Ahmadabad NBOT (National board of trade) located at Indore.

Different types of commodities traded

World-over one will find that a market exits for almost all the commodities known to us. These commodities can be broadly classified into the following:

Precious Metals: Gold, Silver, Platinum etc
Other Metals: Nickel, Aluminum, Copper etc
Agro-Based Commodities: Wheat, Corn, Cotton, Oils, Oilseeds.
Soft Commodities: Coffee, Cocoa, Sugar etc
Live-Stock: Live Cattle, Pork Bellies etc
Energy: Crude Oil, Natural Gas, Gasoline etc

Segments in Commodities market

The commodities market exits in two distinct forms namely the Over the Counter (OTC) market and the Exchange based market. Also, as in equities, there exists the spot and the derivatives segment. The spot markets are essentially over the counter markets and the participation is restricted to people who are involved with that commodity say the farmer, processor, wholesaler etc. Derivative trading takes place through exchange-based markets with standardized contracts, settlements etc. In the spot trade one pays cash and carries the goods. Whereas in future market a person can buy or sale a commodity future on an exchange based on his expectation of where the price will go, wherein the buyer or seller either closes (square off) his account or give/take delivery of the commodity. The broker maintains an account of all dealing parties in which the daily profit or loss due to changes in the futures price is recorded.

Forms of Investing in Commodity Markets:
Investing in commodities comes in two forms: passive and active:

Passive investing is a strategy used by investors who are using commodities as a risk diversification tool. For example, when inflation picks up, it tends to hurt fixed income securities and equities to some extent. However, prices of commodities tend to rise during these periods. This helps diversify your portfolio. Commodity investing has long had a reputation for exceptional volatility and risk but there is now a small but growing number of excellent, high-quality index-based commodity funds available that provide a relatively conservative way to invest in commodities. The management attempts to minimize price fluctuations and provide overall risk management in several ways.

Active investing or actively managing a position in the commodities market can provide good performance results. In periods of economic growth, commodities are in strong demand to satisfy production needs. Because commodity or raw material prices tend to move more quickly in reaction to economic fluctuations than do the prices of the related finished goods, an active approach could lead to economic gains if trading activities are closely monitored and managed by the investor.

Different participants in commodity markets:

There are different participants in the commodity markets who are classified into three categories as follows:
1) Hedgers: This category of people use derivatives to either raise or reduce the risk associated with the price of the asset.
2) Speculators: They use derivatives to get extra leverage by laying a bet on future movements in the price of an asset.
3) Arbitrageurs: They use derivatives primarily for the purpose of taking advantage of inconsistency between the prices of an asset prevailing in the two markets, by taking opposite positions.

Motivations for Investing in Commodities, Commodity Derivatives, and Commodity-linked Securities:
Commodities offer investors a number of benefits as follows:

- ***Hedge against Inflation*:** Commodity cash prices may benefit from periods of unexpected inflation, whereas stocks and bonds may suffer. Commodities are "real assets", unlike stocks and bonds, which are "financial assets". Commodities, therefore, tend to react to changing economic fundamentals in ways that are different from traditional financial assets, particularly with respect to inflation. Commodity prices usually rise when inflation is accelerating, so investing in commodities can give portfolios a hedge against inflation. Conversely, stocks and bonds tend to perform better when the rate of inflation is stable or slowing. Faster inflation lowers the value of future cash flows paid by stocks and bonds because those future dollars will be able to buy fewer goods and services than they would today.
However, this inflation advantage is captured more efficiently by direct investment in commodities than, for example, investment in commodity-related equities whose prices also reflect the financial prospects of the issuer or actively managed commodity futures accounts, which tend to reflect the manager's skills at selecting the right commodities.
- ***Performance/Return:*** Investor interest in commodities has soared in recent years as the asset class has outperformed traditional assets such as stocks and bonds. Over the five-year period ended March 31, 2006, the Dow Jones AIG Commodity Index has returned 10.6%, versus 2.6% for the S&P 500. Part of this superior performance is attributable to a rise in commodity prices driven by increased demand from China and other emerging countries.
- ***Enhanced Diversification:*** Portfolio diversification is the primary benefit of holding commodities. The reason for that is the commodity investor is exposed to commodity futures prices. Changes in those prices reflect changing expectations about future supply and demand for commodities

VI) HISTORY OF COMMODITY MARKET DEVELOPMENT IN INDIA:

The turnover of the commodity market in our country has grown potentially in a short span of time. This market favours more of speculators. The future market leaves a lot to be desired as an effective instrument of risk management and price discovery for the benefit of the growers, traders, processors and other stakeholders. Further the policymakers have looked over the consideration involving the discipline of checks and balances. The opening up of the commodity future market in India was an important initiative taken with an aim to improve domestic market efficiency. It further aids the price discovery process and provides a platform for price risk management in commodities. In September 2013, the regulatory body FMC has been brought under the control of Ministry of Finance. At present 46 commodities are traded in six National Exchanges and 11 Commodity specific exchanges. The futures trading in agricultural products constitute the total turnover in 2013-14, with food items contributing 55.6 per cent and non-agricultural products contributing 17.5 per cent. However, the volume of trade has declined by 39 per cent during 2012-13, over the previous year. The FMC has been implementing the price dissemination scheme to control the inflationary trends and to provide the requisite prices to the farmers. The future markets help the farmers to predict the price, as well as it helps the government to take the pre-emptive reaction when required. Though, it has been noted that the prices has been largely influenced by the Euro-crisis.

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VII) INITIATIVES TAKEN BY GOVERNMENT OF INDIA FOR COMMODITY MARKETS:

The Government of India (Forwards Commission Market along with SEBI) has undertaken various activities and assistance programmes to promote our commodities market. During the year 2012-13 the commission conducted 872 awareness programs, out of which 535 programmes were for the benefit of the farmers and 337 programs for other stakeholders. There were 100 capacity programmes conducted with the aim to build capacities of the important stakeholders in the eco-system of commodity future markets and to sensitize the policy makers about the utility of the futures markets. Out of the total 83 programs were conducted for the general states and 17 were for the NER states. The FMC is association with the Commodity Exchange initiated a process of dissemination of futures and spot prices of agricultural commodity by installing Price Ticker boards at various locations. This may help hedger group like farmers in their pre-sowing and post harvest decision making process and hedging their price risks in the market. The officers of the Commission participated in various international conferences and were also deputed for training/symposium organized by international organizations/training institutes. Further the commission with the National exchange has facilitated participation of hedgers in various exchange programs, exhibitions and expos.

VIII) CHALLENGES TO COMMODITIES MARKET IN INDIA:

Our country, being strongly agriculture based has to contend with the long-term decline and short term volatility of real commodity prices on international markets. The long-term decline in real prices reflects the tendency for productivity and production to grow at a faster rate than demand, leading to over-production which hampers the price provided to the farmers. Whereas the volatility reflects the impact of exogenous factors such as weather on our production of commodities. These problems are exacerbated by market distortions, tariffs and subsidies in developed countries, tariffs in developing countries and the market power in some commodity supply chains of large transnational corporations. These distortions also limit our access to lucrative markets and hinder attempts to secure a greater share of the final product price on the part of our producers and exporting community. To summarize in points following are the problems as faced by commodity markets in India: 1) Legal Challenges 2) Regulatory Challenges 3) Infrastructural Challenges 4) Awareness amongst the investors and producers 5) Other challenges regarding trading.

IX) CONCLUSION:

India is one of the top producers of a large number of commodities ranging, with a long history in its trading commodities and commodity derivatives. These markets have been experiencing ups and downs since its inception, but with strengthening of the working our country has been able to bring a degree of stability to this market. It has been progressing in terms of technology, transparency and trading activity with the removal of government protection from a number of commodities. This action of our government has thus, allowed the market forces i.e. supply and demand, to rule the commodity. Thus the step proves to be a big lesson for all the developing economies that the pricing and price risk management should be left to the market forces rather than to be dependent on the administered price mechanism. As the management of price risk is going to assume greater importance in future with the promotion of free trade in the world.

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